IV. Asymmetric Dominant Carrier Regulation is Costly and Unfair -- There is a Better Regulatory Solution for MLECs

In his landmark book on the economics of regulation, Dr. Alfred Kahn describes effective competition succinctly:

> Effective competition and economic efficiency alike require that lower-cost firms be encouraged, because of their own lower costs, to reduce their prices to take business away from other higher-cost competitors. (Alfred E. Kahn *The Economics of Regulation*, Volume I, 1970. Cambridge, Massachusetts: The MIT Press, 1988, p. 164)

The most effective way to promote economic efficiency in competitive markets is to allow competitive market forces to entice and discipline the behavior of firms. Effective competition requires that all firms must compete on the merits of their respective efficiencies. By contrast, imposing artificial restrictions on one competitor but not another, such as asymmetric rules and responsibilities, can mask the relative efficiencies of firms and thereby allow inefficient firms to displace efficient firms. While such a circumstance may give appearances of competition, this form of rivalry does not constitute effective competition. A level competitive playing field should be encouraged and maintained, not by handicapping the efficient players, but by allowing fair and equitable competition to sort the efficient firms from the inefficient firms.

The primary role of economic regulation is to substitute for competition, where competition is either infeasible or otherwise unworkable. In some cases, certain public service obligations are regulatory imposed on firms (*e.g.*, universal service and COLR obligations) as an instrument to affect certain social policies that may not otherwise be addressed in a competitive marketplace. In any event, the pursuit of these social policies should be largely transparent to the competitive process. The primary objective of regulation in a competitive environment should be to foster an equal opportunity to

compete among market providers without pre-ordaining marketplace outcomes. In other words, the commission should endorse the principle of competitive parity.

Many asymmetric regulations, including the FCC's separate subsidiary requirements applied to MLECs, are both costly and inconsistent with effective competition. Asymmetric regulation may be defined as the practice of imposing market constraints on the incumbent firm not likewise borne by their competitors. In the telecommunications industry, asymmetric regulation has primarily taken the form of (1) pricing constraints necessary to support various social policies; (2) geographically averaged rate structures that do not reflect corresponding cost differences; (3) government imposed obligations requiring incumbent firms to stand by with the service capacity in place to serve consumers on demand, either where other competitors have chosen not to provide service, or in the event of a failure on a rival's network; and (4) information disclosure requirements that force the incumbent firm to reveal in advance (to competitors) plans for new service offerings and associated prices and strategies.

Asymmetric regulation distorts the competitive process. Aside from the obvious efficiency effects of handicapping one firm over another, there has been a long history of asymmetric regulation and the results of past asymmetric regulations have manifested themselves as today's most difficult problems of competition policy.

The true social costs of asymmetric regulation are difficult to measure because they involve market transactions that do not occur but would have otherwise. In other words, the cost of asymmetric regulation are benefits of competition which are foregone. The fact that the FCC continued to regulate the long distance market more than 20 years after competition first emerged is direct evidence of the failure of this policy. Mark Fowler, a past chairman of the FCC, acknowledged the failure of asymmetric regulatory policies in an article written after he left office:

> It can be argued, for instance, that some of the commission's regulatory actions in the interexchange market that were designed to promote competition during transition, such as highly discounted access pricing for OCC's [Other Common Carriers] and restrictions on competitive pricing responses by AT&T, in fact have encouraged entry by uneconomic providers and uneconomic construction of excess capacity. If this is true, the gradualist approach to deregulation of interexchange markets will have resulted in substantial, unnecessary costs for society that never would have been incurred in a truly competitive marketplace. Moreover, this approach will have directly increased consumer costs by requiring regulated firms to charge higher prices to protect competitors during the transition. (Mark S. Fowler, Albert Halprin, and James D. Schlichting, "'Back to the Future': A Model for Telecommunications." *Federal Communications Law Journal*, vol. 38, no. 2, August 1986, pp. 193-194.)

Asymmetric regulation may lead to at least the following four types of social cost.

First, asymmetric regulation fosters technical inefficiency or productive inefficiency because it can preclude the least-cost provider from being the least-price provider. This may occur, for instance, because the MLEC maintains regulatorily imposed public service obligations not borne by its competitors. Hence, asymmetric regulation derails the competitive process and thereby harms consumers.

Second, the regulated firm's public service obligations inflate its costs relative to its competitors because it is required to deploy capital ubiquitously without regard to profitability. On high cost, low density routes, the MLEC is frequently the exclusive provider of service. Yet, because regulation requires that costs be averaged for ratemaking purposes, the incumbent firm's service obligation makes it easier for a relatively high cost entrant to compete with the incumbent firm in the high volume low cost market segments. From the entrant's perspective, saddling the incumbent firm with public service obligation

serves as a means to raise its rival's costs. Moreover, the competitive entrant can default to the incumbent in the event of a network failure because of the latter's ubiquitous deployment of capital and common carrier obligations.[3] From the consumer's perspective, there may be no risk in using the services of a lower priced, low reliability provider because one can always turn to the regulated common carrier in case of need and yet pay no penalty for doing so.

Third, certain information disclosure requirements (*e.g.*, changes in tariffs and service offerings) placed on regulated incumbents often constitute a market advantage to new entrants. This leads to inefficiencies that are subtle and thus more difficult to measure because they involve welfare losses associated with foregone innovation. For example, the incumbent firm may fail to invest in innovation because the information disclosure requirement precludes it from capturing the returns from innovation. When competitive entrants are granted advance knowledge of the incumbent firm's product plans and strategies, they can wrest away first mover advantage from the incumbent firm by delaying it's product introductions or making their own offerings first. In this fashion, asymmetric regulation fosters imitation and stifles innovation. This argument goes beyond the standard critique that the competitive entrant may meet with market success even when it does not have a "better mousetrap". The problem is that the rate at which "mousetrap" innovation occurs is artificially retarded due to asymmetric regulation. This entails dynamic efficiency losses resulting from a sub-optimal level of investment in innovation.

Fourth, asymmetric regulation provides new entrants with a non-market means to compete with the incumbent firm. This constitutes an extraction of profits from the incumbent and a transfer of them to the entrant (sometimes referred to as "rent-seeking" or "regulatory predation"). The entrant may have an artificial competitive advantage in the regulatory arena relative to the incumbent not because of its lower cost, but because the incumbent

[3] This problem may be greatly exacerbated by the resale requirement of the Telecommunications Act of 1996 unless rates are so aligned above cost so as to avoid the need for any subsidies, internal or external.

must bear the burden of proof with regulators and customers while the entrant bears the burden of proof only with customers.

Hence, asymmetric regulation gives rise to an inferior breed of competitor -- more adept at imitation than innovation--more prone to battle in the hearing room than in the marketplace. For these reasons, it is critical that this commission endorse a policy of symmetric regulation and competitive parity to achieve effective competition.

There is a better solution. The following outlines general regulatory principles which should be followed to facilitate effective competition in telephone service markets.

• The first principle is that the regulatory process should enable the development of competition in the industry without mandating it directly or promoting it artificially. The practice of asymmetric regulation is generally inconsistent with this principle.

• The second principle is that regulatory policies should facilitate production by low cost providers. To this end, regulatory policies should be non-distortionary and competitively neutral.

• The third principle stresses the importance of limiting incentives for undesirable arbitrage of regulatory rules. To the extent possible, the regulatory process should be immune to strategic manipulation by the incumbent and competitive entrants alike.

• Fourth, regulatory rules, inclusive of incentive regulation plans, should explicitly include provisions for their own sunset. The overhang of excessive regulation imposes direct costs on society and raises the risk of the indirect costs of potentially harmful marketplace intervention. The preservation of interests established under the regulatory rules tend to be perpetuated by the very availability of such rules.

There are general pricing principles which follow from these economic regulation principles. MLECs should be given the ability to respond to competition. In particular, MLECs should be afforded pricing flexibility regardless of market share, with appropriate safeguards against predation. Such safeguards generally require that prices exceed incremental production costs. The MLEC should be free to set prices at will within pre-determined rate bands or be afforded complete pricing flexibility, with incremental cost serving as the price floor. The overriding objective is to ensure that the least-cost provider is not precluded from being the least-price provider.

Pricing flexibility or other attributes of streamlined regulation, including elimination of separate subsidiary requirements imposed on MLECs, should not be conditioned on some threshold of actual losses in MLEC local market share. This is the practice recommended by all of the incumbent national toll service providers in order to hamstring their new LEC competitors and was an extension of the practice the FCC followed in the continuing regulation of AT&T in the interexchange market, to its competitors' delight. Of course, now that AT&T has the shoe on the other foot (it now faces entry in the toll market and it is now the entrant in the local market and not the incumbent), it prefers that the FCC and state regulators impose costly asymmetric rules on its LEC toll service competitors. These are exactly the same types of regulations it argued against when it was the dominant regulated firm. This is clear evidence of the costs of asymmetric regulation in terms of regulatory rent seeking and demonstrates that this type of regulation is absolutely the wrong policy. It can inadvertently put competitors in the driver's seat for determining when, if ever, regulation of the incumbent should be relaxed. Many toll service providers were very happy to soak up the rain of profits flowing off of the monopoly price umbrella of the regulated incumbent AT&T and the same is true for those competitive toll carriers which face the threat of unfettered entry by LECs, which, for now, remain highly regulated, high cost, high priced toll service providers (assuming that they provide any toll services at all). The existing regulatory handicaps imposed on MLECs which provide interstate interexchange services, such as costly separate subsidiary requirements and

dominant carrier regulations, serve mainly to perpetuate the status quo as it restricts genuine price competition.

In summary, the current asymmetric regulatory regime imposed on MLECs:

- distorts competitive market outcomes
- leads to social welfare losses associated with inefficient market entry
- hinders investment in innovation and technology
- increases the costs of regulation, and, in turn, prices to consumers
- creates opportunities for "gaming" the regulatory system

Market share as an indicator of market power

In fact, market share is not a reliable indicator of market power. This point is made succinctly in a recent paper by Schankerman:

> The market share of a firm is an endogenous variable and is determined by the same fundamental factors that govern market power. Market share does not cause market power any more than market power causes market share. The fact that market power and market share both reflect the underlying efficiency levels of all firms in the industry cannot be overemphasized. A policy which conditioned regulatory streamlining on the incumbent's market share would have the effect of penalizing efficiency and commercial success, and would represent major retrogression from the recent provision of efficiency incentives under price caps. (Mark Schankerman, "Symmetric Regulation for a Competitive Era, paper presented at the Conference on Telecommunications Infrastructure and the Information Economy: Interaction Between Public Policy and Corporate Strategy. Conference sponsored by the School of Business at the University of Michigan. Ann Arbor, Michigan, March 1995.)

Reliance on market share as an indicator of market power is particularly troublesome in regulated markets wherein (1) prices may be maintained below efficient levels and (2) entry/exit restrictions are in place. Landes and Posner have also recognized this point:

> The causality between market share and market power is reversed. Instead of a large market share leading to a high price, a low market price leads to a large market share; and it would be improper to infer market power simply from observing a large market share. (William M. Landes and Richard A. Posner. "Market Power in Antitrust Cases," *Harvard Law Review*, vol. 94, march 1981, p. 976)

Many commenters have pointed out in this and other proceedings that vertically integrated MLECs should be presumed to have market power in the downstream toll market due to their high or even total market share in the upstream local exchange and exchange access market in their traditional service territories. Market share is one of the more important elements of market structure, but it alone does not prove the existence of market power. If a firm does not have a large market share, then it certainly does not have the ability to exercise any market power. If a firm does have a large market share, however, then the possibility exists of the firm having and exercising market power. In other words, market share is a necessary but not sufficient condition for exercising market power. In addition to a high market share, a firm will need to be in an industry with high barriers to entry or with insufficient competition among existing firms and uncommitted entrants so that the firm will have the ability to increase price above the competitive level for more than a short period of time.

Furthermore, in regulated industries, market share does not carry the same meaning and the same weight in the analysis of market power as it does in non-regulated industries. When market share has been created by regulators who have erected artificial barriers to entry (like low subsidized rates for basic service), it does not give a good indication of the

market power the firm would have when faced with competition upon the removal of these artificial regulatory barriers to entry. This point has been recognized by the courts:

> Reliance on statistical market share in cases involving regulated industries is, at best, a tricky enterprise and is downright folly where, as here, the predominant market share is the result of regulation. In such cases, the court should focus directly on the regulated firm's ability to control prices or exclude competition. [Metro Mobile CTS, Inc., v. New Vector Communications, Inc. 892 F. 2d 62, 63 (9th Cir. 1989)]

An assessment of market power should focus on whether or not there is competitive behavior. An element of market structure, such as market share, can provide strong evidence that there is no market power if the market share is low, but it alone is not evidence of market power if the market share is high. In the latter case, a more complete investigation is necessary. First, low barriers to entry will result in competitive behavior. Second, the investigation will consider the degree of rivalrous behavior among firms in the industry. In addition, the ability of a firm's competitors to expand and provide a competitive challenge for the firm's business is also important. Only in the absence of easy entry and sufficient competition from other firms in the industry would the firm be able to exercise market power over its customers. In regulated markets which are opened up to competition, such as the local exchange market of today, the proper analysis should hinge on post entry prospective market conditions *i.e.*, what would market behavior be in the presence of reduced or no regulation. Or, as in the case being considered in this proceeding, the proper analysis would be based on prospective market conditions including the top level regulatory constraints imposed on the LECs requiring that all unregulated competitors enjoy non-discriminatory cost based access to the LECs unbundled network components and interconnection arrangements.

In order to not sacrifice normal dynamic efficiency gains derived from successful business behavior, regulatory policies should not even attempt to eradicate all entry barriers in the local telephone service marketplace. The only barriers to entry that regulators should be concerned with are artificial, those created in accordance with or facilitated by the regulatory process itself. Entry barriers that derive solely from the operating efficiencies and business acumen of the MLEC are not the province of regulatory policies. In this vein, it is important that regulatory policies clearly recognize the distinction between competitive rivals that cannot jump and entry barriers that are too high.

For example, assume that a particular MLEC has built a reputation for being a high quality, reliable service provider. To an existing or potential competitor, this may constitute a barrier to entry, especially if they have a relatively poor track record for providing quality and timely service and reliability. No one would seriously propose, however, that regulators implement some type of asymmetric rules designed to eradicate this barrier to entry. The following excerpt from Schumpeter captures the spirit of this principle.

> The first thing to go is the traditional conception of the *modus operandi* of competition. Economists are at long last emerging from the stage in which price competition was all they saw. As soon as quality competition and sales effort are admitted into the sacred precincts of theory, the price variable is ousted from its dominant position. However, it is still competition within a rigid pattern of invariant conditions, methods of production and forms of industrial organization in particular, that practically monopolizes attention. But in capitalist reality as distinguished from its textbook picture, it is not that kind of competition that counts but the competition from the new commodity, the new technology, the new source of supply, the new type of organization (the largest scale unit of control for instance)--competition which commands a decisive cost or quality advantage and which strikes not at the margins of the profits and the outputs of the existing firms but at their

foundations and their very lives. (Joseph A. Schumpeter, *Capitalism, Socialism and Democracy*, Harper and Row, 1975 (first published in 1942), p. 84)

The Schumpeterian view of competition is that of an evolutionary process. The perennial gale of "creative destruction" pits firm against firm and product against product in a constant struggle for market dominance. Market dominance is rewarded with high profits, not penalized with competitive handicapping. In this context, the following point cannot be overemphasized: the level playing field refers to an equality of opportunity to compete -- not an equality of marketplace outcomes. A regulatory preoccupation with market share mistakenly focuses on the latter.

V. Conclusion

From an economic perspective, separate subsidiaries are not necessary for the MLECs' provision of interstate, domestic interexchange services that originate in their local exchange areas because the risk of anti-competitive control of bottleneck facilities has been superseded by the combination of: 1) the Telecom Act's elimination of entry barriers and the MLEC's lack of market power, and 2) effective competition from other toll service providers.

Given the new competitive environment, the FCC's proposal to retain the separate subsidiary requirement for interstate interexchange represents, at best, the imposition of redundant and costly regulation, and, at worst, a significant barrier to entry to those LECs wishing to compete "head to head" with other unregulated players in the market.

The FCC's preliminary findings and proposed rules retaining a separate subsidiary requirement for interstate interexchange which participate in the market for interstate interexchange services is not consistent with the realities of the new competitive market for telecommunications services fostered by the Telecommunications Act of 1996. Congress made clear that the overarching spirit and intent of the Act was to promote competition in

both local and toll markets by empowering the FCC to engage in genuine deregulation -- that is, the elimination of burdensome regulatory rules where they are no longer needed. Whether or not, or under what circumstances, the FCC ultimately finds that the separate subsidiary requirement for LEC entry into interLATA markets should be lifted for the BOCs, the Commission should immediately lift it for MLECs. The elimination of the separate subsidiary requirement on MLECs' provision of interstate interexchange service is a good place to start the process of genuine deregulation.

Regulatory rules designed to safeguard new market entrants from the wrath of giant incumbents like the RBOCs are not appropriate for MLECs. Such regulations will, instead retard the efficiency and competitiveness necessary for the new marketplace.

The above discussion and analysis leads to the conclusion that MLECs, are not dominant and do not have market power. Barriers to entry are low, particularly for entry into their territories, and the threat of entry and competition already serves to restrain their ability to control prices for virtually all telecommunications services and, particularly, interstate interexchange services. The FCC should, therefore, practice genuine deregulation by classifying MLECs as non-dominant interstate interexchange service providers, thereby affording them the regulatory freedom and opportunity to pursue their competitive business plans.